

**IN THE
SUPREME COURT OF MISSOURI**

No. 83888

**MEDICINE SHOPPE INTERNATIONAL, INC.,
Appellant,**

v.

**DIRECTOR OF REVENUE,
Respondent.**

**On Petition for Review from the
Missouri Administrative Hearing Commission
Honorable Willard C. Reine, Commissioner**

**BRIEF OF RESPONDENT
DIRECTOR OF REVENUE**

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INTRODUCTION

This case addresses the taxation of income for Missouri Corporations. Section 143.451 (RSMo. 2000)¹ allows corporations to use the single factor apportionment method to compute taxable income. Under that method, corporations pay taxes on income from Missouri sources using a formula described below. This cases addresses the meaning of “income from sources within this state” as used in §143.451.2 and the classification of income under the single factor apportionment method found in §143.451.2(2).

The single factor method allows businesses to calculate their taxable income in the following manner: the amount of business transacted wholly in this state is added to one-half of the amount of business transacted partly in this state and partly in other states. The sum of those numbers is divided by the total amount of business transacted in all states. The total amount of net income is then multiplied by the factor obtained.

The way the “single factor” statute works is shown by a simplified hypothetical. A corporation transacts \$300,000 of business. Of those total transactions, \$100,000 is in transactions wholly in Missouri, \$100,000 is transaction partly in Missouri and \$100,000 is transactions occurring wholly outside of Missouri. Assume further that, after expenses, the net income was \$200,000. The calculation would work as follows: \$100,000 (business wholly in Missouri) is added to \$50,000 (half of the partly in Missouri business). The total (\$150,000) is divided by the total amount of business

¹ All citations will be to RSMo. 2000.

transacted (\$300,000), producing a factor of 0.5. Then total net income (\$200,00) is multiplied by 0.5. The Missouri taxable income then is \$100,000.

In this case, Medicine Shoppe International's original tax returns for 1990, 1991 and 1992, reported the income at issue here – income from loans made to franchisees – as business transacted in Missouri. L.F. 43.² Thereafter, beginning with its 1993 returns, Medicine Shoppe classified this very same income as “non-Missouri source income.” L.F. 43. In 1995, Medicine Shoppe continued its reclassification amending its 1990-92 returns to report the transactions as non-Missouri source. L.F. 44. Medicine Shoppe claimed that the income from loans was not subject to apportionment (not net income), and therefore was not taxable by the State of Missouri. Medicine Shoppe claimed its tax liability was thereby reduced and that it was entitled to refunds.

The director denied the claim for refunds and found that the income at issue was Missouri source income and should be included with other Medicine Shoppe income that was included in net income subject to the single factor apportionment method. The Director then classified this income as partly within Missouri and partly in other states for purposes of the apportionment percentage. L.F. 46.

This court must now decide whether the state has the right to tax the income at issue as Missouri source income and how it should be classified for purposes of apportionment. The Director and the

² For the Court's convenience, a copy of the Administrative Hearing Commission's opinion is included in the appendix to this brief.

Administrative Hearing Commission found that the income at issue was generated by transactions in part in this state and in part in other states and therefore was subject to taxation as Missouri source income under §143.451.2. L.F. 54. Medicine Shoppe contends that because the income was from capital employed outside of Missouri, it “is not Missouri source income subject to tax under Section 143.451.”

App. Br. at 15. Medicine Shoppe does not argue that the factor was calculated incorrectly, but that the income at issue is subject to absolutely no taxation by Missouri under the factor or otherwise.

Simply put, the question is should Medicine Shoppe, a business located and conducted within the State of Missouri, pay Missouri taxes on income from loans it made to its out-of-state franchises?

JURISDICTIONAL STATEMENT

This appeal involves the construction of a state revenue law. Article V, Section 3 of the Missouri Constitution gives this court exclusive jurisdiction.

STATEMENT OF FACTS

Medicine Shoppe's brief omits several relevant facts:

Medicine Shoppe's primary business was franchising retail pharmacies. L.F. 35. All of Medicine Shoppe's offices are located in the State of Missouri. *Id.* All of Medicine Shoppe's officers, including the CEO, who had authority to enter into franchising agreements, and the CFO, who had authority to enter into finance agreements with franchisees, were located in the state of Missouri. L.F. 36. Medicine Shoppe conducted its marketing, operations, financing and servicing from its St. Louis Headquarters. *Id.* When Medicine Shoppe chose to finance franchises, Medicine Shoppe conducted the credit review, made the decision to accept the financing arrangement and made its disbursement of funds in St. Louis. *Id.*

Medicine Shoppe provided financing and other services "for the sole purpose of maintaining and enhancing the quality of existing franchises or developing and expanding new franchise business." L.F. 41. When it sought new franchises, Medicine Shoppe's marketing materials include statements indicating that financing could be provided. *Id.* Money lent to franchisees from Medicine Shoppe was to be used only for items related to the operations of the franchise. L.F. 42. Medicine Shoppe's financing agreement itself reflects that financing is offered to "qualified prospective or existing Licensees desiring to open a Medicine Shoppe Pharmacy." Joint Exhibit GG.

Once a franchise was established, Medicine Shoppe provided several services including assistance in locating physical space for the franchise, guidance concerning operations of the franchises, and advertising. Joint Exhibits N-Q. Medicine Shoppe required its franchises to operate according to a specific system and had the right to take over a franchise. *Id.*

POINTS RELIED ON

The Administrative Hearing Commission did not err in denying Medicine Shoppe's claims for refund. That decision was correct under Section 143.451 RSMo. which requires Medicine Shoppe to pay tax on income from sources within this state including from transactions partly within this state. Medicine Shoppe's franchising activities within this state or partly within this state generated income from loans made as part of that franchising activity. Medicine Shoppe's Missouri operation also provided services to its franchises that generated the income at issue here.

§ 143.451 RSMo. 2000

J.C. Nichols Co. v. Director of Revenue, 796 S.W. 2d 16 (Mo. banc 1990)

Wohl Shoe Co. v. Director of Revenue, 771 S.W.2d 339 (Mo. banc 1989)

Maxland Development v. Director of Revenue, 960 S.W.2d 503 (Mo. banc 1998)

The Administrative Hearing Commission did not err when it upheld the Director's assessment of additional taxes for the 1991, 1992 and 1993 tax years. Rule 84.04 requires Medicine Shoppe to identify the ruling or action being challenged. Medicine Shoppe's brief only challenges the Administrative Hearing Commission's ruling with respect to its claims for refunds, and therefore abandons the Commission's ruling with respect to additional assessments and overpayment. Mo. R. Civ. Pro. 84.04

Thummel v. King, 570 S.W.2d 679 (Mo. banc 1978)

ARGUMENT

STANDARD OF REVIEW

Medicine Shoppe had the burden of proof before the Administrative Hearing Commission (AHC). § 621.050.2, RSMo. This Court must uphold the AHC's decision if it was authorized by law and supported by competent and substantial evidence upon the entire record, and if it is not clearly contrary to the reasonable expectations of the General Assembly. *Jones v. Director of Revenue*, 981 S.W.2d 571, 574 (Mo. banc. 1998); *Becker Electric Co. v. Director of Revenue*, 749 S.W.2d 403, 405 (Mo. banc 1988); § 621.193, RSMo.³ Under this standard, this court essentially adopts the AHC's factual findings. *Concord Publishing House v. Director of Revenue*, 916 S.W.2d 186, 189 (Mo. banc 1996).

³ Medicine Shoppe's brief cites to the correct statutes in its point relied on, but in its argument incorrectly cites §621.189 for the standard of review spelled out in §621.193. App. Br. 8.

I. The Administrative Hearing Commission did not err in denying Medicine Shoppe’s claims for refund. That decision was correct under Section 143.451 RSMo. which requires Medicine Shoppe to pay tax on income from sources within this state including from transactions partly within this state. Medicine Shoppe’s franchising activities within this state or partly within this state generated income from loans made as part of that franchising activity. Medicine Shoppe’s Missouri operation also provided services to its franchises that generated the income at issue here.

Section 143.451.2 requires that Missouri corporations pay taxes on income derived from sources within this state, “including that from the transaction of business in this state and that from the transaction of business partly done in this state and partly done in another state or states.” Medicine Shoppe does not dispute that its business of franchising is within this state, yet it attempts to avoid taxes on income produced from loans made as part of that franchising activity. Neither a plain reading of the statutes, nor case law, allows Medicine Shoppe to completely avoid taxes on income generated from business transacted in part within this state.

A. Section 143.451.2 is Unambiguous and Requires Corporations to pay taxes on Income from Transactions in this State or Partly in this State.

Section 143.451.2 requires corporations to include in Missouri taxable income all income from sources within this state including that from transactions done wholly or partly within this state.

Medicine Shoppe alleges that income from loans made as part of their franchising business (i.e. loan

origination fees and interest from loans)⁴ is “not Missouri source income.” App. Br. 15. A plain and ordinary meaning of the statutes, as required by §1.090, points to a contrary result.

The legislature has not seen fit to define the term “source,” so the courts turn to the plain meaning of the term as defined in the dictionary. *Lincoln Industrial v. Director of Revenue*, 51 S.W.3d 462, 465 (Mo. banc 2001). “Source” is defined as “a generative force or stimulus: [synonyms are] CAUSE, INSTIGATOR.” *Webster’s Third New International Dictionary*, 1993. The legislature specified that Missouri source income “includes transaction of business partly done in this state and partly done in another state or states.” §143.451.2 RSMo. The plain meaning of the statute is that taxable income is income generated or stimulated from transactions wholly or partly performed within Missouri. The facts of this case demonstrate that loan origination fees and interest were

⁴ The AHC decision indicates that the only income at issue before the AHC was “income from loan origination fees and interest income on money loaned.” L.F. 34. But Medicine Shoppe’s brief appears to broaden the issue to add “service charges on accounts receivable and interest income from service charges on the late payment of license fees.” App. Br. 6. The legal analysis is the same for all income derived from loans to franchisees.

generated, caused, and instigated by the franchising transactions occurring, at least in part, within Missouri.

The AHC found, as a matter of fact, that Medicine Shoppe's franchising activities occur within the State of Missouri and the loans are made for the purpose of contributing to and supporting franchising activity. (L.F. 41) Because the income from loans is generated by franchising transactions, it is taxable.

Medicine Shoppe is in the business of franchising retail pharmacies. L.F. 35. During the periods at issue, Medicine Shoppe did not have any offices outside the State of Missouri. *Id.* The officers who entered into franchising and finance agreements were located in Missouri. L.F. 36. It conducted its activities from its St. Louis headquarters. Those activities included marketing, operations, accounting, finance, advertising, third-party contracting and servicing franchises. *Id.* Medicine Shoppe cannot, and does not, dispute that its franchising activities occurred, at least in part, within the state.

The franchising activities in Missouri were the "source" of the income from financing within the meaning of the statute because the financing was caused or instigated by the franchising activities. Medicine Shoppe's annual reports stated that financing of franchisees was "for the sole purpose of maintaining and enhancing the quality of existing franchises or developing and expanding new franchise business." L.F. 41. The possibility of financing was used in advertising materials to solicit potential franchisees. *Id.* Medicine Shoppe's financing agreement itself reflects that financing is offered to "qualified prospective or existing Licensees desiring to open a Medicine Shoppe Pharmacy." Joint Exhibit GG. Money loaned to franchisees was to be used "only for items related to the operation of the franchise." L.F. 42.

The facts contained in the record and found by the AHC conclusively establish that the income at issue was caused by the franchising activities which occurred, at least partly, within this state. Financing was exclusively for the purpose of attracting, maintaining and sustaining franchises. The financing would not occur if not for the in-state franchising activities. Under a plain meaning of the statute, the source of the income at issue is the franchising activities.

Medicine Shoppe attempts to draw a distinction between financing and the rest of its franchising activities as if those things occur independent of each other. App. Br. 15. Even if this court should find that financing is somehow separate from the business of franchising, the income therefrom is taxable. Medicine Shoppe asks this Court to focus on where the money that forms the loan is located. But the statute has no room for such an analysis. The statutory focus is not on where the money ends up at the end of the day, but on the transaction that generates the investment and whether any part of that transaction occurs in Missouri. If it does, the transaction is included as Missouri source income – subject to taxation – under the statute. If Medicine Shoppe’s analysis was correct, Missouri corporations wishing to reduce tax liability should move all of their funds out of Missouri banks into other states. Because the capital is located outside of Missouri, they would owe no Missouri tax on the interest generated by those funds – under Medicine Shoppe’s theory. Neither Medicine Shoppe nor amicus Missouri Banker’s Association can seriously suggest that the court adopt such an interpretation of the statute.

Rather the focus is on the location of the transaction that forms the source of the income. As discussed above, Medicine Shoppe would not enter into the financing arrangements but for the marketing and administrative franchising activities that occur in Missouri. Moreover, when a franchise is

financed by Medicine Shoppe, the credit review, decision to accept, disbursement of funds and filing of security interest is done in Missouri. L.F. 36. The financing agreements are entered into by Medicine Shoppe officers located in the state of Missouri. *Id.* The financing arrangement is generated by the activities that occurred in Missouri. Therefore, the financing transaction itself occurs wholly or partly within Missouri and the income therefrom is taxable under the statute.⁵

That is the end of the inquiry. The Director and the AHC correctly found that the income Medicine Shoppe derives from its financing of franchisees originates in Missouri because it would not exist but for Medicine Shoppe's franchising activities that occur here. Using a plain meaning of the statute, the loan origination fees and interest generated from Medicine Shoppe's financing activity are incomes from sources within this state just as the other income from franchising activities is included in that calculation. Even if financing could be factually separated from franchising, the income would be taxable because it arises from a transaction occurring partly in the state of Missouri.

B. Case Law Also Supports the AHC's Decision

⁵ There is some evidence in the record that the franchising and financing transactions occurred wholly in Missouri. (See L.F. 39) The Director, however, construed the statutes in favor of the taxpayer and found these transactions to be only partly conducted with the state.

Medicine Shoppe relies instead on *Petition of Union Electric Company of Missouri*, 161 S.W.2d 968 (Mo. 1942) a case pre-dating the current statute and analyzing a completely different set of facts. The AHC relied on *J.C. Nichols Company v. Director of Revenue*, 796 S.W.2d 16 (Mo. banc 1990), a case interpreting the statute at issue with very similar facts. While the *Nichols* decision does not specifically engage in a plain meaning analysis, the opinion reaches the same result in similar fashion. Other cases, not relied on by the AHC or discussed in appellant's brief, lead to the same result.

i. *Nichols*

Nichols involved a Missouri company that owned income-producing land in Kansas. The company claimed that income from Kansas property was not Missouri-source income under the same statute at issue in this case. This court rejected the company's argument. The *Nichols* court reviewed prior cases, which all state the same rule in several ways: "[A] transaction is partially within . . . Missouri 'if the Missouri effort is among the efficient causes which contribute directly to the production of income.'" *Id.* at 17-18, quoting *Wohl Shoe Co. v. Director of Revenue*, 771 S.W.2d 339, 342 (Mo. banc. 1989). In determining the source of taxable income, a court should look to where "the brains" of the operation are located. *Nichols* 796 S.W.2d at 18, citing *Bank Building and Equipment Corporation of America v. Director of Revenue*, 687 S.W.2d 168, 171 (Mo. banc 1985). Finally, a court should consider the location of "overall effort" which produced the income as well as the location of the "management structure which produced the income." *Id.* See also *Hayes Drilling v. Director of Revenue*, 704 S.W.2d 232, 234 (Mo. banc 1986); (Income produced by "an overall effort centered in Kansas City, Missouri" is Missouri source income. The Kansas City effort is the "*sine qua non* of [the] enterprise.") All of these statements of the rule reflect the clear meaning of the statute: income generated in part by activity in the State of Missouri is taxable in Missouri.

The facts of this case fall within the test discussed in *Nichols*, no matter how that test is articulated. The "brains" of Medicine Shoppe's operation are located in St. Louis. The Missouri operations are the "efficient cause" of the franchising, the financing, and the income therefrom. The "overall effort" and "management structure" are located within this state.

Medicine Shoppe's brief attempts to distinguish this case from *Nichols* by arguing that in *Nichols* the income was derived from the use of "labor (i.e. the active management and decision-making surrounding the real estate)." App. Br. at 16. It is difficult to see how Medicine Shoppe's active management and decision-making surrounding its franchises and financing is any different. In *Nichols*, and in this case, the business was identified, solicited and supported from within the state of Missouri. More importantly, the income would not exist but for the activities that were conducted in this state. Even though the thing of value (land or a loan) may be physically located outside of the state. The income was generated and created, at least in part, by activities within this state. It is income from a Missouri source.

Nichols applies whether this court finds the income to be as a result of the franchising activities or from a financing arrangement separate from the franchising transaction. In either case, the overall effort was in Missouri. But if this court chooses to treat financing as somehow separate from franchising, the *Wohl Shoe* case is even more directly on point.

In *Wohl Shoe* this court held that income from shoe sales that occurred outside of Missouri generated taxable income in this state because the sales were approved here. "The decision to accept an order is a critical part of the transaction and is, we believe, one of the efficient causes contributing directly to the production of income." *Wohl Shoe*, 771 S.W.2d at 342. Because Medicine Shoppe's CFO in Missouri entered into the financing agreements, those transactions occurred partly within Missouri and *Wohl Shoe* is dispositive.

ii. *Nichols* progeny

Nichols has never been overruled. That decision focuses on how income-producing investments come into being. Two cases since *Nichols* purport to follow *Nichols*, but focus the test in a slightly different way. The Commission's decision is consistent even with those variations on the rule. In *Lemay Bldg. v. Director of Revenue*, 889 S.W.2d 835 (Mo. banc. 1994) the court considered a real estate holding company headquartered in Missouri which owned a mobile home park in Florida. The court held that income from the park was Missouri source income. The taxpayer "clearly maintained enough participation and control to be an efficient cause contributing directly to the production of [the Florida] income." *Id.* at 837.

More recently, in *Maxland Development v. Director of Revenue*, 960 S.W.2d 503 (Mo. banc 1998), the Court focused on whether control of management "rose to the level of an 'efficient cause' which contributes directly to the production of the income." *Id.* at 506. Several corporations were involved in *Maxland*. They had varying levels of investment and involvement in out-of-state shopping centers. The Court held that income from the shopping centers was taxable in Missouri for some of the corporations because of their involvement in the management of the property. But other taxpayers were engaged in a "passive investment" and were not an efficient cause of the income. They "provided no services" to the shopping center. Therefore, the income was "wholly without this state." *Id.* at 506-507.

Although Medicine Shoppe's brief does not advance this argument, one might read these two cases to say that the inquiry should focus on Medicine Shoppe's level of involvement in the operations of the franchises. While *Nichols* and *Wohl Shoe* focus on how an investment came into being -- what

caused the income -- *Maxland* and *LeMay Bldg.* seem to focus on the taxpayers involvement with the investment after it has been made – whether taxpayer activity is an “efficient” cause of ongoing income. In other words, could the profitability of the franchises (the investment) be sufficiently influenced by Medicine Shoppe’s provision of “services” and its management involvement?

Although the AHC did not analyze the case with this question in mind, - and therefore did not make its own factual findings on the issue - the undisputed facts of the case demonstrate that, unlike the passive investor in *Maxland*, Medicine Shoppe provided numerous services to its franchisees. Medicine Shoppe franchise agreements are called “license agreements” and are Joint Exhibits N through Q to the stipulated facts.⁶ Those licensing agreements give Medicine Shoppe a great deal of control over the management of the franchises and establish that Medicine Shoppe provides services which are an efficient cause of income produced by the franchises.

The preamble to the licensing agreements (paragraph 1.A. of each Exhibit) summarizes that level of involvement:

“Individuals who meet our qualifications and are willing to undertake the investment and effort to establish and develop a MEDICINE SHOPPE Pharmacy are granted licenses to develop and operate MEDICINE SHOPPE Pharmacies offering the products

⁶ For the Court’s convenience, a copy of one such agreement is included in the appendix to this brief.

authorized and approved by us and utilizing the formats, designs, signage, layouts, methods, specifications, standards, operating procedures, guidance and Marks which comprise the [Medicine Shoppe] System” (Emphasis supplied.)

The remainder of the agreement is replete with services that Medicine Shoppe provides to its franchisees:

Section 2 specifies that Medicine Shoppe will select and approve a physical location for the franchise. Medicine Shoppe will also designate territory to prevent competition from other franchises. Medicine Shoppe negotiates the lease or sublease for the premise. If the franchisee wishes to buy a location, Medicine Shoppe must approve the sale. Medicine Shoppe provides specifications for the building of the pharmacy.

Section 3 provides that Medicine Shoppe assists in advertising and promotion of the opening of the franchise. In section 4, Medicine Shoppe provides training to its franchisee. The franchisee and his managing pharmacist must complete the training to the satisfaction of Medicine Shoppe, or Medicine Shoppe can terminate the agreement. Medicine Shoppe provides guidance to the franchisee concerning all aspects of the operation and they provide accounting services.

In section 5, Medicine Shoppe provides “marks” which must be used and displayed prominently by the franchise, they indemnify franchisees for use of the marks and may cause the franchisee to stop using the marks at any time. In section 7 franchisees agree to operate their stores in accordance with detailed systems and standards spelled out in the agreement. In section 8, Medicine Shoppe agrees to plan, create, direct and produce advertising for the franchisees. Section 9 allows Medicine Shoppe to inspect its franchisees, conduct audits and sales surveys. Medicine Shoppe may

take over operation of the facility if franchisees are not in compliance with the requirements of the agreements and Medicine Shoppe is irrevocably appointed attorney-in-fact for the franchisee if, in Medicine Shoppe's sole discretion, a take over is necessary.

Having both retained and exercised such authority in its franchising agreements, Medicine Shoppe was not a "passive" investor in these franchises. Unlike the taxpayers in *Maxland* and in *Union Electric*, discussed below, Medicine Shoppe provided services that influenced the operation of and income from the investment. In *Maxland*, and in the hypothetical investment situation discussed by amicus (see *amicus* brief at 26), there was nothing the taxpayer could do to influence the income that was generated from his out-of-state investment. In this case, Medicine Shoppe can actively influence the income from the investment by exercising its rights under the licensing agreement. The ability to exercise such control is sufficient. *Lemay*, 889 S.W.2d at 837. Moreover, Medicine Shoppe did influence that income by providing a myriad of services including choosing a site, providing management guidance and advertising.

iii. Petition of *Union Electric* and *Goldberg*

Although Medicine Shoppe's brief cites *Petition of Union Electric* for the proposition that "income derived from the loan of money used by a non-Missouri entity wholly outside of Missouri is not Missouri source income under Section 143.451," (emphasis added) (App. Br. 11.) Medicine Shoppe fails to point out that *Petition of Union Electric* pre-dates the 1972 passage of Section 143.451 *et seq.* The statute analyzed in *Union Electric* taxed income "from all sources within this state" but did not include the current statute's clarification that sources within this state includes income from "transaction of business . . . partly done in this state." *Petition of Union Electric*, 161 S.W.2d 968,

970 (Mo. banc 1942). The added statutory language may explain why this Court did not find *Union Electric* necessary to its analysis in *Wohl*, *Nichols*, or *Maxland*. *Petition of Union Electric's* simplistic analysis of where income has been produced has been abandoned in modern cases⁷, but even if *Union Electric* were still good law – in light of statutory changes and more recent cases ignoring its analysis and focusing on transactions – it does not require a ruling in *Medicine Shoppe's* favor.

In *Union Electric* “it [was] conceded that the actual expenditure of labor and the actual use of capital which gave rise to the income represented by these dividends took place outside the state of Missouri.” (emphasis supplied) *Id.* at 971. In this case, no such concession is made. The labor, the “brains,” the management that generates the income is within the state of Missouri.⁸ In addition,

⁷ For example, *Petition of Union Electric* states that income from the sale of capital assets occurs where the sale occurs. *Id.* Such a statement is contrary to later decisions of this court pointing out that “transactions” are more than just “sales.” See *International Travel Advisers, Inc. v. State Tax Commission*, 567 S.W.2d 650, 654 (Mo. banc 1978); *Wohl Shoe*, 771 S.W.2d 339.

⁸ Amicus Banker's Association makes much of the *Union Electric* case and indicates that Union Electric “must have decided” to do a series of activities related to investment of funds. What Union Electric did to generate the income is not clear from the opinion. It is reported, however, that at least part of the income came from a common law trust “organized outside the state.” It may well be that Union Electric took absolutely no steps within the state to generate the income, but rather sat idly while affiliated companies, operating wholly in other states, generated income back to Missouri.

Union Electric is a “passive investor” case within the *Maxland* analysis, because the taxpayer there had no influence over how much income was generated by its out-of-state investment. As the facts of this case make clear, Medicine Shoppe had much more control over its investment.

Nor is *Petition of Union Electric* consistent with the other case cited by Medicine Shoppe, *Goldberg v. State Tax Commission*, 639 S.W.2d 796 (Mo. banc 1982). App. Br. 13. *Goldberg* rejects a focus on “sales” and points out that the statute’s focus is on the broader term “transactions.” *Id.* at 803. *Goldberg* is conclusive evidence that *Petition of Union Electric*’s analysis of the source of income has been abandoned.

Medicine Shoppe points out that *Goldberg* reaffirmed the source of income test, a point the Director does not dispute.⁹ The issue here is not *whether* the source of income test applies, but how it

⁹ In making its point, Medicine Shoppe implies that there is more to *Goldberg*’s affirming of the source of income test than is found in the case. The Director does not concede that *Goldberg* allows corporations to subtract “non-Missouri source” income from net income (*See* subpoint C, below), rather *Goldberg* acknowledges that the source of income test is embodied in the statutes itself. *Goldberg*, 639 S.W.2d at 801.

should be applied. *Goldberg* is of no help to Medicine Shoppe in this analysis. Furthermore, *Goldberg* involved the sale of tangible property, income from which is governed by a specific set of statutes. While Medicine Shoppe spends a good deal of time on the facts of *Goldberg*, the court specifically held that statutes passed after the taxable year at issue in *Goldberg* would have treated the income at issue there as taxable. *Goldberg* n. 7. Finally, *Goldberg* was about how to calculate the apportionment factor and there was no dispute that the income was taxable by Missouri.

None of the cases Medicine Shoppe cites should divert the court from a basic point: in *Nichols* and *Wohl* it analyzed the same statute at issue here and came to a well-reasoned decision based on a long line of cases and consistent with the plain meaning of the statute. Because Missouri activities caused the investment and effected the income, the income is income from sources within this state.

C. This Court has an opportunity to clarify the source of income test.

The decision of the AHC in this case should be upheld using the standards applied in *J.C. Nichols*, *Maxland* and all other cases applying the source of income test. But this case could also be decided in a manner that clarifies the test and returns to a plain meaning of the statute. Judges of this Court have suggested that opinions on the source of income test have not been “mechanical.” *Langley v. Administrative Hearing Commission*, 649 S.W.2d 216, 219 (Mo. banc 1983) (Welliver, J., dissenting). In *Goldberg*, the dissent pointed out the “decisional inconsistency” and “conflicting results” in cases up to that time. *Goldberg*, 639 S.W.2d at 809 (Higgins, Rendlen and Morgan, JJ., dissenting). At times, members of the court have become so frustrated by the difficulties involved in applying the “source of income” test that they have expressly advocated scrapping the entire

single factor apportionment test. *Dow Chemical Co. v. Director of Revenue*, 1989 Mo. Lexis 93, *20 (Welliver, J., concurring) *on rehearing* 787 S.W.2d 276 (Mo banc 1990). The task of applying the statute is no easier today.

First, the Court creates confusion and iniquity if it continues to follow the rule articulated in *Brown Group Inc. v. Admin. Hearing Comm.*, 649 S.W. 2d 874, 881 (Mo. banc 1983). *Brown Group* held that non-Missouri source income should be excluded from net income in the single factor calculation. The decision in *Brown Group* was contrary to a plain meaning of the statute which specifies how to arrive at taxable Missouri source income – you do so by using a formula that starts with all income then allocates out an approximation of the income that was earned outside of Missouri to arrive at income from sources within this state.

The statute does not allow what *Brown Group* holds, the complete deduction of non-Missouri source income from net income by judicial interpretation rather than by the formula set out in the statute.

If this court continues to follow *Brown Group*, however, it should clarify that non-Missouri source income includes only that income from transactions that occur completely outside of Missouri.

i. *Brown Group* was wrongly decided

Brown Group has been “bitterly, and . . . justifiably criticized” by at least one former member of this court and legal commentators. *Dow Chemical (I)*, 1989 Mo. Lexis 93 at *14. (Welliver, J., concurring). *Brown Group* ignores a plain reading of the statute and allows Missouri corporations to completely avoid Missouri taxes on income that it classifies as non-Missouri source income by excluding it from “net income.” *Brown Group*, 649 S.W.2d at 881.

But the statutes are very clear in this regard. §143.451.1 specifies that corporations shall pay tax on income from all Missouri sources, then §143.451.2(2) explains how to arrive at that figure. The statute says: “the taxpayer may elect to compute the portion of income from all sources in this state in the following manner [outlined in subsection (b)].” The express language of §143.451.2(2) points out that §143.451.1 is not the end of the analysis as *Brown Group* held. The legislature specified that the manner for calculating Missouri source income is found in §143.451.2(2) not in §143.451.1's general statement that taxable income includes income from sources in this state. When read together, the statutes outline a reasonable approach starting with the premise that Missouri intends to tax all income from sources in this state and then laying out an objective and mathematical test for figuring what income is from a source within this state.

The calculation does not apportion the income on a transaction-by-transaction basis, but allows a taxpayer to elect to proceed under the mathematical formula of §143.451.2(2)(b). Further evidence that §143.451.2(2)(b) is a method for arriving at Missouri source income is the fact that corporations are not required to use this formula, but “may elect” to compute Missouri source income using the simple and objective single factor method. *Maxland Development*, 960 S.W.2d 503, 506.

To do so, the taxpayer first calculates a factor using as the numerator the sum of business transacted wholly in this state and one half of business transacted partly in other states. The denominator is total business transacted. Then – and this is where *Brown Group* went awry – the “net income” of the corporation is multiplied by that fraction to arrive at taxable income. In this way, non-Missouri source income is separated out using the formula – it is deducted from all income in proportion to the amount of business transacted in other states. Under the statutory scheme, not all

corporate income is subject to tax, only that portion that is Missouri source as determined by the statutory formula.

Brown Group's interpretation subtracts non-Missouri source income from net income in the first instance, then subtracts non-Missouri source income again by use of the formula. But the statute does not allow for such an interpretation, it says clearly that "net income" should be multiplied by the factor. §143.451.2(2)(b). In order to follow *Brown Group*, this Court must add words to the statute to say that Missouri source net income shall be multiplied by the factor. Such a reading is not consistent with the plain meaning of the statute and is much more than a strict interpretation in favor of the taxpayer, it is a rewrite of the statute.

Brown Group also creates a scheme that punishes Missouri-only businesses. Missouri businesses which conduct their transactions solely in Missouri must pay taxes on all of their income. Missouri businesses that are engaged in business transactions in part in Missouri and in part in other states, pay taxes on a portion of their income as determined by the factor even though some of that income is generated from activity in other states. But Missouri businesses that complete transactions in other states, without contact with Missouri, are allowed to exclude that income from taxation altogether. Such a result is not found in the statute. The Court can correct this inequity by abandoning *Brown Group*.

Overturning *Brown Group* would not abandon the "source of income" test, but would clarify that the test is found in the mathematical formula spelled out in the statutes. Returning to the statutory test would abandon the *Brown Group* approach to Missouri source income that forces taxpayers and the Director to search the case law for guidance. Frequently, as they did in this case, the Director and

the taxpayer read the cases differently. The statute offers the taxpayer the ability, if they so elect, to trade in this case-by-case uncertainty for a mathematical formula that is used to approximate Missouri source income.¹⁰

ii. If followed, *Brown Group*’s application should be clarified

If the Court continues to exclude non-Missouri source income in the first instance, rather than through the single factor method, it should clarify the application of the rule by re-iterating the analysis used in *Wohl Shoe*. Begin by identifying the transaction that created the income and identifying where that transaction occurred. Unless every part of the transaction occurred outside of Missouri, the transaction should be considered “partly in this state” and included as Missouri source income and in the partly in this state portion of the factor. Using that analysis in *Wohl Shoe*, the court held that because a sales transaction was approved in Missouri, it occurred in part within Missouri. *Wohl Shoe*, 771 S.W.2d at 342.

J.C. Nichols purported to follow *Wohl Shoe*, but did not engage in a specific transaction analysis, instead focusing on “efficient cause.” *Nichols*, 796 S.W.2d at 18. *Maxland* followed in

¹⁰ We do not imply that each transaction’s place in the formula will be self-evident. There may still be disputes about where a transaction fits in to the pro-rata factor, but the terms in the factor are more clearly defined by the statutes. See §143.451.2(3).

1998 and cited *Wohl Shoe*, but in *Maxland* the court did not specifically analyze the transaction that created the income; instead it focused on management control. *Maxland*, 960 S.W.2d at 509.

Although the test as articulated in *Maxland* may be simply a variation on the “cause test” – treating management as a series of transactions – it is anything but mechanical. It requires a “case-by-case” analysis. *Id.* at 506. Thus *Maxland* does little to give the Director of Revenue guidance on how to classify an out-of-state investment that results from a transaction partly within Missouri.

The *Wohl* test articulated above is consistent with a plain meaning of the statute. When the legislature mandated that corporations pay taxes on “all income from sources within this state, including that from the transaction of business partly done in this state and partly done in another state or states” it decided that transactions partly in this state are a subset of income from sources in this state. By contrast, *Maxland* might be read to say that the transaction creating that investment could have occurred partly in this state, but because the income was actually generated elsewhere – without the possibility of management control from Missouri – the source was not in this state. Such a reading of *Maxland* places too much emphasis on the “efficient” in the phrase “efficient cause,” the Court had used in previous cases. *See Hayes Drilling v. Director of Revenue*, 704 S.W.2d 232 (Mo. banc 1986). The statute does not require that the transaction be an “efficient cause”; it simply says that transactions in part in this state are to be included in Missouri-source income.

If the court continues to follow *Brown Group*, clarifying its breadth by use of the *Wohl* test would not mean that all income to a Missouri corporation must be included as net income nor would it effect the apportionment factor. *Wohl Shoe*, 771 S.W.2d at 342. It would simply clarify that corporations cannot remove income from “net income” simply by investing out of state. Rather the

non-Missouri source income must be income that is not generated by Missouri transactions. Such an interpretation would avoid “an overzealous application of the strict construction rule resulting in an exclusion of income from that portion taxable in Missouri in more instances than would be dictated by any consistent legislative intent which motivates the taxation of income only from sources in Missouri.” *Goldberg*, 639 S.W.2d at 810 (Higgins, J., dissenting).

Application of the *Wohl* test to Missouri source income would not necessarily require this court to over-rule cases like *Brown Group* and *Maxland* which find that some investments outside of Missouri are wholly outside of the state. Neither of those cases specifically discusses the transaction that created the investment. They skip straight to an analysis of the investment itself. In *Brown Group*, it is possible that the agreements to use trademarks, patterns, etc., were the result of transactions wholly outside of Missouri, but because the opinion did not focus on that issue, those facts are not included in the case. *Brown Group*, 648 S.W.2d at 874-880. Nor does *Maxland* include a discussion of the location of the transaction that created the investment. We know that a Missourian signed the lease agreements (the investment), but we have no idea where those transactions, or any parts thereof, occurred.

Abandoning *Brown Group* would be consistent with a plain meaning of the statute. Re-affirming the transaction test for determining Missouri source income if *Brown Group* is followed will provide necessary certainty to the Director, the AHC, and most important, businesses that pay taxes in this state.

D. The Director is not Taxing Invested or Re-invested Funds

In sub-point E of its point relied on Medicine Shoppe claims that the loan origination fees and interest income were an investment and reinvestment of funds and therefore are excluded from taxable income by §143.451.2(2)(b). App. Br. 17. Medicine Shoppe apparently did not see fit to raise this argument before the Administrative Hearing Commission. *See* AHC decision at 17. Therefore, it is waived. *Blevins Asphalt Construction Co. v. Director of Revenue*, 938 S.W.2d 902-903 (Mo. banc 1997).

The argument must fail at any rate. Neither the Director nor the Commission included the invested funds themselves in a calculation of taxable income. Rather the income generated by the loans is all that was included in the calculation. L.F. 53. §143.451.2(2)(b) presently excludes from the formula used to figure taxable income “[t]he investment or reinvestment of [Medicine Shoppe’s] own funds, or sale of any such investment or reinvestment.” That statute only applies to the apportionment factor and does not exclude income from the initial net income figure. Furthermore, in order to adopt Medicine Shoppe’s line of reasoning, and exclude the income even from the apportionment factor, this court would be required to re-write the statute to exclude income from the investment of Medicine Shoppe’s own funds, not just the invested funds themselves. Such a construction of the statute is not possible.

II. The Administrative Hearing Commission did not err when it upheld the Director's assessment of additional taxes for the 1991, 1992 and 1993 tax years. Rule 84.04 requires Medicine Shoppe to identify the ruling or action being challenged. Medicine Shoppe's brief only challenges the Administrative Hearing Commission's ruling with respect to its claims for refunds, and therefore abandons the Commission's ruling with respect to additional assessments and overpayment.

The AHC upheld the decisions of the Director of Revenue and assessed additional taxes for the 1991, 1992 and 1993 tax years in the amounts of \$33,633.57, \$29,118.51, and \$89,806.03 respectively. L.F. 55. The AHC also upheld the decision of the Director with respect to overpayments for the 10-95 and 11-95 tax periods. *Id.* Finally, the AHC denied Medicine Shoppe's claim for refunds. *Id.* Yet Medicine Shoppe's sole point relied on assigns error for "denying appellant's claims for refund." App. Br. 7.

An appellant's brief must set forth the "action or ruling" of which the appellant wishes to complain. Mo. R. Civ. Pro. 84.04. Failure to do so preserves nothing for review. *Thummel v. King*, 570 S.W.2d 679, 685 (Mo. 1978). Because Medicine Shoppe's brief does not challenge the AHC's decision in any respect other than the denial of refunds, the brief does not preserve the other decisions of the Commission for appellate review. Should this court find that a challenge to the additional assessments and overpayments is preserved, the same legal reasoning that applies to refunds would apply to those decisions as well. The Director therefore incorporates by reference the legal arguments in Point II of this brief.

CONCLUSION

Medicine Shoppe's taxable income must include income from Missouri sources including that from transactions partly within Missouri. §143.451.2. Loan origination fees and income from loans made to franchisees were income generated by transactions partly performed in this state. That income was generated either by the franchising activity itself, which occurred partly in this state, or by a separate financing transaction, which also occurred partly in Missouri. Furthermore, Medicine Shoppe had the authority to exercise significant control over its franchises and therefore had the ability to generate income by activities it carried out within Missouri.

The AHC decided that the income at issue was from transactions partly within the state. The AHC considered evidence that Medicine Shoppe's offices and officers were located within this state and that the transactions at issue in this case occurred, at least partly, within the state. This evidence was competent and substantial and the AHC's decision was not clearly contrary to the reasonable expectations of the General Assembly. Therefore, the decision should be upheld. *Jones v. Director of Revenue*, 981 S.W.2d 571, 574 (Mo. banc. 1998); *Becker Electric Co. v. Director of Revenue*, 749 S.W.2d 403, 405 (Mo. banc 1988); § 621.193, RSMo.

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Certification of Service and of Compliance with Rule 84.06(b) and (c)

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The undersigned certifies that the foregoing brief complies with the limitations contained in Rule No. 84.06(b), and that the brief contains 8,311 words.

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